VII. FIVE-YEAR FORECAST

Preparation of the five-year revenue forecast is complicated by unprecedented financial challenges resulting from the downward spiral of the economy and the magnitude of the State's budget problems. In more stable times, the forecast can assist decision-making by providing a longer-term perspective on budget decisions. However, in the current economic climate, a five-year projection is much less reliable as there are no definitive signs the economy is improving enough to impact local revenue sources. The continuing uncertainty of the level of impact the State's problems will have on City finances renders the result of an economic forecast potentially useless.

Historical Information, Major Assumptions and Forecast Methodology

The forecast is for Fiscal Years 2003-04 through 2007-08. The City is currently facing significant, and quite possibly unprecedented, financial challenges. The General Operating Fund, the primary provider of City services, is experiencing severely constrained finances and is not able to maintain the current level of City services. With the significant decline in General Operating Fund revenues over the past two years, there is no longer sufficient revenue to cover even inflationary increases in General Operating Fund expenditures.

Even though economic growth was dramatic in the Bay Area in recent years, past experience has demonstrated the cyclical nature of the economy, especially in Silicon Valley. While the current financial challenges facing the City are substantial, it is fortunate the potential for a serious economic adjustment was identified in previous years. Techniques such as creation of the Economic Stabilization Contingency and a Budget Transition Reserve have allowed the City's adjustment to financial challenges to be less traumatic than would otherwise be the case and will continue to provide flexibility into the future.

As discussed during the budget process, Sales Tax, Hotel Tax, Utility Users Tax, Investment Earnings and Franchise Fees were below budget for Fiscal Year 2002-03. The General Operating Fund ended the fiscal year with a $4.4 million operating balance, higher than estimated as a result of the cumulative effect of the ongoing hiring freeze and significant departmental cost-cutting efforts. While this $4.4 million balance is better than anticipated at any point during the past fiscal year, it is $954,000 less than the carryover from Fiscal Year 2001-02 and drastically reduced from the $20.7 million balance at the end of Fiscal Year 2000-01. Although the stock market has made small gains, and there are possible indications of an economic recovery nationwide, the local economy, which is driven by the high-tech industry, remains in a slowdown and will probably continue to be, through the end of the 2003-04 fiscal year. The State-wide unemployment rate has risen to 6.8 percent but is 8.6 percent in Santa Clara County. Companies continue to reduce staffing in an effort to control costs; low mortgage interest rates, which have been fueling consumer spending, have recently begun to rise; the commercial vacancy rate continues to be at or above 25 percent; and business-to-business sales are still very slow. A secondary effect of these conditions is significantly reduced business and leisure travel, which negatively impacts transient occupancy tax.

Projections of the major revenue sources are based upon and affected by the variables discussed below:

- Property tax revenue is impacted by real property prices, assessed valuation, ownership changes triggering reassessments, the level of development activity and the proportionate share of that activity to the rate of growth in the remainder of Santa Clara County. The County proactively reviewed commercial and residential properties again for Fiscal Year 2003-04 and has processed numerous reductions. Although some of the assessed value reductions implemented by the County Assessor for Fiscal Year 2002-03 are projected to be restored for Fiscal Year 2003-04, the remainder will continue to have a dampening effect on the rate of revenue growth into the future until the value is restored to the current market value.

- Sales tax revenue is subject to economic, technological and political challenges, and local business decisions. Currently, the most significant challenges are corporate relocations, the severe decline in the local economy and the decline in business-to-business sales. During the 2002-03 fiscal year, two major corporations relocated to other cities, severely decreasing sales tax revenue generated in the City.

- Other Taxes:

  — Transient Occupancy Tax is impacted by the number of hotel rooms, the room and occupancy rates and the tax level.

  — Utility Users Tax is dependent on the cost of energy, customer base and consumption levels.

- Investment earnings are based on the portfolio balance and yield.

- Licenses, Permits and Service Charges are primarily impacted by the level of development within the City.

Expenditures are trended based on historical experience, assumptions about future growth rates using information gathered from various sources, extrapolations based on the 2002-03 fiscal year, previously negotiated labor agreements and future costs of the Fiscal Year 2003-04 Adopted Budget. The expenditure forecast does not assume any additional programs, positions or service level enhancements.

Conclusion

The General Operating Fund balance in Fiscal Year 2004-05 indicates a negative balance of approximately $1.0 million, growing to $8.3 million by Fiscal Year 2007-08, and does not include any reservation for the Economic Stabilization Contingency after Fiscal Year 2003-04. The funding gap is certain to be exacerbated by any State actions implemented to resolve its own significant fiscal crisis. This projection highlights the continuing necessity of managing the City's expenditures and developing all possible revenue sources.

The forecast is updated annually as part of the budget process. Revenue trends are closely monitored and compared to expenditures in the preparation of the budget and each fiscal year appropriate budget proposals are developed based on projected revenues.

Included with this memo is a detailed presentation of the forecast, summarizing, in graphic form, the revenues described above and the assumptions used to prepare the forecast.